

## IV. Direct Method Statement of Cash Flows – Components and Crosswalks

Producing a Statement of Cash Flows may be a new statement. If your entity is an enterprise fund, or other business-type activity, chances are a statement of cash flows was prepared in previously issued financial statements.

GASB 34 requires the **direct method** of preparing cash flow statements for business-type activities. Under the **direct method**, cash receipts and disbursements for the fiscal year are determined. The indirect method, which is more widely used, adjusts net income for items the affected reported net income, but did not affect cash. The calculations in the indirect method are largely performed by analyzing changes in balance sheet accounts. The difference between the two methods only affects the **net cash flow from operating activities**.

There are four required classifications of cash flow:

1. Operating Activities
2. Non-capital Financing Activities
3. Capital and Related Financing Activities
4. Investing Activities

### a. Operating Activity Cash Flows

**To create the operating activities section of the statement of cash flows, accrual data must be converted into “cash basis.”** A reconciliation of this conversion must be presented at the bottom of the statement. Inflows of cash are aggregated by major type and outflows are reported by payment type.

We have agreed that the following is to be our policy of what are inflows and outflows. **Though these are illustrative and non-authoritative, please adhere to these categories, as deviation will only cause confusion when aggregated into the Commonwealth’s financial statements.**

OPERATING ACTIVITIES	
INFLOWS	OUTFLOWS
<b>Cash received from Customers</b> (may be directly named in the following categories, if material:) <ul style="list-style-type: none"> <li>Fares, fees, tolls and primary operating charges</li> <li>Auxiliary Revenues – rents, parking etc.</li> <li>Research Contracts and Grants</li> <li>Federal Operational Appropriations</li> <li>Reimbursement Receipts</li> <li>Interest</li> <li>Unrestricted gift receipts that do not finance capital projects</li> <li>Other operating cash inflows</li> </ul>	<b>Cash payments to</b> (should be directly named in the following categories:) <ul style="list-style-type: none"> <li><b>Payments to Employees</b></li> <li><b>Payments of Employee Benefits</b></li> <li><b>Payments to Vendors and Suppliers</b> – includes utilities, contractors, books, food, vendors, operating leases.</li> <li><b>Loans to Employees</b></li> <li>Other operating cash outflows</li> </ul>

**Loans issued to employees and Loan repayments from them** should not be netted.

**b. Non-Capital Financing Cash Flow**

By far the most controversial portion of the Statement of Cash Flows is the placement of **State Operating Appropriations** under Non-Capital Financing cash flow and not operations. GASB Statement 9, paragraphs 20 and 21, include proceeds from all borrowings not clearly attributable to construction, acquisition or improvement of capital assets also in this category. Specifically, paragraph 21 states:

Cash inflows from noncapital financing activities include:

- Proceeds from issuing bonds, notes and other short- or long-term borrowing not clearly attributable to acquisition, construction, or improvement of *capital* assets (*emphasis added.*)
- Cash receipts from grants or subsidies except (1) those specifically restricted for capital purposes and (2) those for specific activities that are considered to be operating activities of the grantor government.
- Cash received from other funds except (1) those amounts that are clearly attributable to acquisition, construction, or improvement of *capital* assets, (2) quasi-external operating transactions, and (3) reimbursement for operating transactions.
- Cash received from property and other taxes collected for the governmental enterprise and not specifically restricted for capital purposes. (e.g. PILOT payments made to governments.)

Cash outflows would largely mirror the inflows named in a to d above.<sup>9</sup> The Commonwealth's yearly appropriations for your component unit would probably be classified under item 'b' above. Item c would rarely occur in a component unit in the Commonwealth. The only possibility would be if an entity such as the MBTA paid for a portion of a entity's operations in some way, shape, or form. An example of item d would be any PILOT payments to a community made by a school.

**c. Financing Activities Cash Flow**

Financing activity cash flow is mainly derived from funds received and expended for construction and acquisition of capital assets. The inflows include funds from debt issuance, capital appropriations, capital grants and gifts received that are connected with capital activity. The outflows are funds used for purchases of capital assets, principal payments on capital debt and leases, interest paid on capital debt and leases and deposits with third party trustees for escrows (*not reserve funds.*)

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<sup>9</sup> Statement 9, Paragraphs 20-22.

#### d. Investing Activities Cash Flow

Investing activities are straightforward. These activities include purchases and sales of all investments and the interest earned thereon. These investing activities **include purchases and sales of reserve funds related to bond transactions.**

From these four categories, your entity should easily be able to determine the net increase or decrease in cash for the year. Using the direct method, however, a further reconciliation is required, which equates operating income or loss to net cash provided by (or used in) operating activities. A simple equation is as follows:

Operating Income (loss)	\$xxx,xxx
Adjustments to reconcile net income (loss) to net cash	
Provided by (used in) operating activities:	
Depreciation and amortization expense	
Changes in assets and liabilities:	
Receivables – net	
Inventories	
Other Assets	
Accounts Payable	
Deferred Revenue	
Deposits held for others	
Compensated absences	
Loans	xxx,xxx
Net Cash provided by (used in) operating activities	\$xxx,xxx

For those who have done an indirect method of presentation of cash flows, the above reconciliation is the operating section of the statement. In the appendix to this guide, (Appendix F,) a translation of a statement of cash flows from an indirect method to a direct method is included. We also encourage you to work with your outside auditing firm to gain any further understanding of the preparation of the statement.